IBM response to Reserve Bank of New Zealand Consultation Paper:

Review of the outsourcing policy for registered banks

IBM thanks the Reserve Bank of New Zealand for the opportunity to respond to the consultation paper 'Review of the outsourcing policy for registered banks'. We are pleased to provide our perspective based on our experience within both New Zealand and the wider region as a global provider of outsourced technology solutions.

In our opinion, the consultation paper is primarily concerned with linking a current regulatory approach to the oversight of material bank outsourcing, with existing Open Bank Resolution (OBR) requirements (i.e. statutory management following failure or positive supervisor intervention).

We consider the document seeks to reinforce two key responsibilities of bank management:

1. the ability of bank management to control, manage and maintain their capital and liquidity positions, provision and interpretation of their financial management information (MI), and production of regulatory reporting; and
2. provide, evidence and maintain appropriate risk management and mitigation measures arising from outsourcing, to avoid increased risk of (or inability to resolve) a bank failure, and the consequential impact on the maintenance of a sound and efficient financial system.

Consequently, we believe the expectations are not onerous for banks and reflect regulatory expectations, activities and practices seen in other jurisdictions. The requirements as they would relate to IBM should be supportable through existing IBM policies and procedures. The outsourcing prohibitions where they exist are appropriate and proportionate and would not be expected to impact existing IBM Infrastructure outsourcing agreements.

We agree that the principal issues identified present a risk to the statutory management and subsequent recovery of a bank. The outsourcing of material Information Technology activity to an experienced, controls and outcomes focussed organisation like IBM reduces technology outsourcing risk and is able to support regulatory intervention, subsequent statutory management or a bank recovery plan.

In conclusion, we would support the recommendations made within the discussion paper covering the expected controls and activities for regulated banks wanting to outsource a material activity. We enclose detailed responses to the individual questions below, together with justification and explanation where required.

IBM welcomes the opportunity to discuss our responses in detail. Please contact myself should you require any additional information or explanation of our answers.

Yours sincerely,

Ben Teague

Detailed Responses

Q1: Do you agree with the analysis of the problem? Do you agree that the issues identified in paragraph 21 appropriately identify the potential problems with the banks' use of outsourcing?

Yes. The analysis of the problem and issues identified in paragraph 21, are common risks associated with a banks approach to outsourcing. However, IBM's experience is that a bank's decision to outsource their technology processing to IBM can reduce the risks as outlined in the discussion paper for the following reasons:

- Management of technology by a world leading technology company can ensure higher standards, enhanced quality of service, and access to developing technologies, not necessarily available to a bank, whose core business is banking.

- IBM's design, support agreements, controls identification and performance, management and experience lessens the risk of a material failure of technology. For example, IBM can demonstrate competence, world-wide standardisation, automation, integration and transformation capabilities.
- IBM's design provides tested and documented business continuity and disaster recovery plans for a bank's operations.
- IBM's approach to system design, delivery and availability takes into consideration the location of services and risks of geographical concentration, event contagion, planned systems growth, security, availability, integrity and capacity.
- Developments arising from the recent Trans-Pacific Partnership (TPP) agreement may further increase flexibility of availability of alternate solutions going forward.
- IBM contracts and detailed Service Level Agreements in place to support the identification of potential points of failure and/or reporting of poor levels of service, including both change and incident management routines.
- IBM applies its global experience and knowledge of regulations world-wide to establish baseline procedures and repeatable, consistent controls that incorporate auditing and reporting practices. This helps to ensure compliance with prevailing regulations, reduces complexity for IBM, our customers and the regulators.
- Up-to-date system documentation provides transparency of the solution, conformance to Open Bank Resolution (OBR) objectives of continued statutory management, and the ability to return or transfer ownership.

These baselines enable bank management to remain focussed on running the bank, whilst maintaining accountability for outsourced activities, oversight of technology operations and management of risks associated with a banks use of technology outsourcing.

We agree that the issue identified in paragraph 21 relating to bank owners and managers' responsibilities for outsourcing at the point of a failure could be a risk to the statutory management and subsequent recovery of a bank. However, an experienced, controls and outcomes focussed organisation like IBM, can provide IT operations and continuity of service to a bank at risk of failure it is able to and support regulatory intervention, subsequent statutory management or a bank recovery plan.

IBM maintains business continuity and disaster recovery plans sufficient for its business, and if contracted to do so its clients, including testing and maintenance programs that provide for rehearsal exercises.

A regulatory outsourcing policy that supports OBR reduces the risk of a bank failure impacting the financial system. Like New Zealand, most geographies apply a preventative regulatory approach that establishes responsibility for outsourcing risk assessment, due diligence, notification and ongoing monitoring of material outsourced activity to a bank's senior management and board. The bank notifies the regulator of material outsourcing activity and demonstrates oversight and control through both annual, and as required, monitoring and reporting.

Q2: Without an outsourcing policy, how would you propose that a failure is managed?

Without an outsourcing policy that addresses bank failure and/or supplier failure, the regulator would need to place greater reliance on individual contractual arrangements between a bank and its supplier. This would increase regulatory involvement and may lead to inconsistencies and additional contractual complexity. By introduction of an outsourcing policy that establishes standardisation of approach and contractual expectations, together with templated notification, the Reserve Bank establishes a minimum and consistent level of control, supporting and enabling the Reserve Banks stated objective of sound financial systems management.

Q3: Do you agree that the current outcomes-focus should be retained?

Yes. An outcomes based approach enables the both the bank and the outsourced supplier to adopt the most cost effective and design appropriate solution, within the constraints of the overall policy thereby enabling a solution that is appropriate for individual banks.

Focus should continue to be on the stability, soundness and efficiency of the financial system protecting the customers and financial organisations and avoiding damage to the wider financial system.

Q4: Do you agree that changing the objectives to focus more on resolution is right?

Yes. The adoption of resolution outcomes is complementary to the outsourcing policy. There could be a gap between a bank's OBR statements and an ability to support their delivery due to inappropriate outsourcing risk appetite or incomplete contractual requirements for the provision of service/availability of information in a statutory management situation.

Q5: Do you agree that the current outcomes are appropriate? Do you agree that the outcomes should also include a resolution-focused requirement? Please explain.

Yes. An outcomes focussed solution, rather than a prescriptive solution, allows the bank and outsourcer to be flexible. Whilst it would not be appropriate for IBM to comment directly on banking activities such as settlement, credit and market risk positions, or balance sheet data requirements (49 a. b. and c.), IBM appreciates the need for the ongoing availability of technology to enable the continued operation of the bank under OBR/Statutory management. If the bank is part of a group/parental relationship, this should include operating as a standalone entity and being capable of being tested as such.

By linking the Outsourcing Policy to Open Bank Resolution, it should support the prudential approach of providing a range of exit options, including continued operations. Bank resiliency and resolution planning should be in place for all key activities, particularly those which are outsourced, in order to ensure that appropriate stressed scenarios and events are considered. Stressed scenarios and events (including supplier and bank failure), should be documented and tested and remediation/support plans should be assessed and documented.

The outsourcing contract should not only support continued operation under statutory management but also enable subsequent adoption/novation as part of a permanent solution. This approach supports the regulators objective of maintaining a sound and efficient financial system, thereby avoiding significant interruption/damage that could result from a bank failure.

Separation plan

Q6: Do you agree that the matters identified above are the appropriate matters for inclusion in a separation plan? Are there any matters that have not been identified above, but should be included?

Yes. A separation plan is the bank's strategic approach to supporting itself as a standalone entity in an OBR event due to either parental failure or a lack of parental support. The development and testing of such a plan should be included as part of the banks stress testing for Basel. The approval of the plan by local management must be a requirement if it is to be taken seriously by the regulator and the plan must be demonstrated to be actionable.

In the event of a parental failure, the local bank should assume (based on regulatory policy and local bank stability/liquidity), that continued operation is the primary objective. The requirements represent two core management activities:

- running the bank from a going concern perspective, and
- technology provision.

With respect to the technology provision, a banking subsidiary would require detailed plans of alternatives to be in place, if it is reliant on parental in-house technologies. In contrast, the use of an independent outsourcer like IBM, whilst still requiring appropriate planning and documentation, significantly reduces the risks and inherent timescales for separation associated with the use of parentally sourced technologies.

Proposed inclusion of a definition of outsourcing

Q7: Does the proposed definition appropriately define outsourcing? If not, please provide an alternative definition that, in your opinion, better captures what is meant by the term outsourcing.

Yes. The proposed use of the Basel definition of outsourcing:

> "Outsourcing is defined in this policy as a registered bank's use of a third party (either an affiliated entity within a corporate group or an entity that is external to the corporate group) to perform activities on a continuing basis that could be undertaken by the registered bank, now or in the future."

is appropriate and reflects the globally accepted definition used by most regulators. This provides a consistent approach across jurisdictions for use by regulated entities and outsourced providers alike.

Functions that are generally not considered relevant for the outsourcing policy

Q8: Are there any other functions that should be excluded from the outsourcing policy, but are not captured in the list above?

There are no additional functions to be excluded.

Prohibition on outsourcing certain functions

Q9: Do you agree that there are functions that are so integral to carrying on the business of a bank that they should not be outsourced? Do you agree that these examples are appropriate? Are there any other functions or systems that should not be outsourced?

Yes. Outsourcing must not result in the delegation by senior bank management of their responsibilities. The core management activities, decision-making and risk acceptance must remain the responsibility of the regulated entity and should not be passed to a third party.

A bank must be capable and in control of calculating its financial position using its own data. The bank should be capable of initiating and accepting payments, and be able to create and understand its regulatory reporting requirements and responsibilities. These elements are consistent with demonstrating compliance with the Basel 'Use Test', i.e. that bank management knows, understands and can articulate the financial position of the bank; and that bank management derives that knowledge from the policies, procedures, reporting systems and tools used by the bank on a daily basis to manage its business, and inform its decisions on strategy.

IBM also believes that choosing to outsource material and non-material activities that are not part of a bank's core functions or strengths (e.g. technology, security, banking application development), can significantly reduce both risk and cost to the bank. This does not impair the bank's ability to manage the third party vendor and apply appropriate oversight - particularly where the third party is an acknowledged expert who has both local and global knowledge of the activity to be outsourced, and is recognised as a leader in that field.

This approach is often seen as an advantage, allowing the bank to focus on core banking activities and target costly bank resources appropriately, rather than for example, maintaining costly in-house technology resources in which it is not an expert.

Process for engagement with the Reserve Bank

Q10: Do you think an outsourcing arrangement compendium would be useful as a reference record between the Reserve Bank and a bank?

Yes. We agree that maintaining a formal record of all outsourced arrangements would assist in both the management of suppliers and the relationship with the regulator, in addition to the ongoing monitoring (and reporting to the Reserve Bank) by the regulated banking entity. We believe this would enable the codification of existing best practice across mature banks within the jurisdiction.

The provision of a framework to determine the necessary process of engagement between banks and the Reserve Bank would assist in ensuring greater consistency in the management of potential outsourcing arrangements for a bank and would ease management, communication and review by the Reserve Bank.

Compendium

Q11: Are there any other matters not addressed above that should be included in the compendium?

Yes. It may be appropriate to include key dates (e.g. signing and renewal dates) associated with outsourced contracts to enable immediate identification of any potential resource constraints/stress points and change risk, not otherwise clearly identified; in addition to confirmation of the availability/continuity of signed contracts, and existing separation and continuity plans.

As suggested by the Reserve Bank the compendium should be a confidential document and not shared. The compendium information would be used for material outsourcing vendor management; maintenance of a bank's OBR strategy and detailed plans; periodic risk assessment; senior management/board oversight and subsequent approval.

Q12: What are the costs to you of establishing and maintaining an outsourcing arrangement compendium that forms part of your conditions of registration?

This question is not directly applicable to IBM. However, we would expect that in a mature banking environment with appropriate risk management controls and governance oversight already in place, the information required should be readily available, if not already documented. Consequently, there should not be significant additional cost. Where any additional costs are incurred, this would reflect improved risk awareness, and a control improvement for the bank's operations and senior management oversight.

Contractual provisions

Q13: Do you agree that all contracts for outsourcing arrangements should be required to include the terms outlined in paragraph 81?

Yes. We agree with the Reserve Bank's approach outlined in paragraph 81, that

a) contractual provisions should ensure continuing access to services on existing commercial terms if a bank enters statutory management;
b) parallel rights for arrangements made through the parent or a related party to ensure continuing access to the services where the bank is separated from its parent; and
c) the ability for the Reserve Bank to have access to documentation and information related to the outsourcing arrangement.

This will ensure continuity for bank customers and support the outcome objective of the Reserve Bank to protect and promote a sound and efficient financial system. Further, the requirement to seek and obtain access to outsourcing arrangement documentation is an existing requirement and common to clients across many global jurisdictions where IBM provides services.

We also note the contractual terms listed in Appendix 1 of the consultation paper (and repeated below), which form the outline of a robust approach to an outsourcing agreement. IBM routinely reviews these elements to determine their appropriateness within individual agreements.

a. the scope of the arrangement and services to be supplied;
b. commencement and end dates;
c. escrow arrangements;
d. review provisions;
e. pricing and fee structure;
f. service levels and performance requirements;
g. the form in which data is to be kept and clear provisions identifying ownership and control of data;
h. reporting requirements, including content and frequency of reporting;
i. audit and monitoring procedures;
j. business continuity management around how the service provider will deal with a failure of the service it is providing;
k. confidentiality, privacy and security of information;
l. default arrangements and termination provisions;
m. dispute resolution arrangements;
n. liability and indemnity;
o. sub-contracting; and
p. insurance.

Options for engagement with the Reserve Bank - *Preferred option – option two*

Q14: Do you agree that option two is the most appropriate option for the assessment of outsourcing arrangements? Please explain.

Yes. We agree that option 2 provides a transparent and potentially faster process for the Reserve Bank and requesting bank alike. The approach follows the previously discussed structured approach for a mature bank with respect to the oversight and control of third party suppliers. We agree that a 20 day period for initial consideration is fair and in line with what we have seen globally.

However, please note that with respect to Appendix 3 'Template for engagement with Reserve Bank - option 2', points 3 and 4 are not applicable to IBM. Notwithstanding that banks will need to complete appropriate analysis and risk assessments to support this; IBM believes that with regard to our size, local, regional and global financial strength, and our industry reach, we are uniquely able to provide support and substitute services from a variety of locations based on an individual bank's risk appetite, contingency plan and/or strategy. It is extremely unlikely that IBM as a supplier would be unable to deliver the contracted service from alternate locations, and unlikely that local substitutes would be immediately available given technology lead times. The strengths of IBM include our local and global market presence and capacity, but also our knowledge, expertise and experience in understanding and documenting operational and technology controls and processes, and reacting to and recovering from, potential impacts to service.

Where a more detailed consideration/non-objection request is required (option 1), perhaps either due to the uniqueness of a solution, sensitivity of the bank, significant increase in risk or other reason, the more detailed approach outlined in paragraphs 87 – 90 is considered appropriate. When the Reserve Bank requests a more detailed review, it is anticipated and recommended that a more detailed dialogue with the regulator should be entered into by the regulated entity, and timescales would need to be agreed on a case-by-case basis.

However, we recommend that additional attention should be given to the following two items:

1. *develop realistic contingency plans that would enable the outsourced function to be provided by an alternative service provider or brought in-house if required. These contingency plans should be tested by the bank if the outsourcing proposal is approved.*

   A risk assessment may need to be included for outsourced activities where there may be no current alternate solution/supplier. In these cases, the only alternate solution may result in wind-down of the activity, or to bringing it in-house. This could unduly influence/impact the development on new market differentiating initiatives.

   and

2. *that the bank has the ability to cancel the contract.*

   It would be difficult to conceive that an outsourcing entity would be willing to invest resources in an arrangement if the contract could be dissolved at any time without recourse, other than in the case of material non-performance.

Overall IBM welcomes the formalised engagement approach for material outsourcing. We believe the structured approach and opportunity for client engagement and dialogue will reduce risk and the opportunity for misunderstanding. This in turn enables a dialogue on the introduction of new technologies, approaches, and controls, which can demonstrate risk reduction and mitigation techniques. This engagement process will also enable bank management to demonstrate their understanding of the new technologies and solutions (e.g. Cloud), and share their approach to the oversight, security, recoverability and integrity of systems, and customer and bank data, in an outsourced environment.

Q15: Do you agree that the approach outlined above is an appropriate way to manage the assessment of outsourcing proposals? If not, please explain.

Yes. The approach adopts a repeatable, prescriptive, yet proportionate process when considering either the use of the template and/or the detailed questionnaire (i.e. where further information is requested). Care will need to be taken when considering the robustness of substitutional arrangements as referred to in the response for point 1. in Q14 above.

Q16: Do you agree that having standardised applications would assist in reducing the time taken to assess outsourcing proposals?

Yes. A standard process and use of a template will ensure the availability of required information to enable the regulator to:

- identify and review inherent levels of risk posed by outsourcing activities both individually and within the geographic market;
- review the controls and oversight established by management;
- ensure a holistic regulatory view of risks and controls in the financial market; and
- advise on, and maintain continuity and safety of the financial markets and customers.

Q17: How many requests per annum do you expect to file in a business-as-usual state? How many requests do you expect to file at the outset of the policy?

IBM considers this information to be commercially sensitive.

Threshold

Q18: Do you think that that the threshold for the outsourcing policy should be aligned with the threshold for OBR pre-positioning, given the inter-linkages of the two policies? Would your bank impacted by an alignment? If so, provide detailed comments.

Whilst IBM cannot directly comment on the impact to banks, option '2' to align outsourcing with the OBR pre-positioning threshold establishes a more level playing field across New Zealand banks and provides a more consistent and perhaps more secure outcome for customers.

IBM would most likely be unaffected as we support the OBR approach today, through support for the development and testing of OBR plans, providing for continuity of operations in the event of a bank failure, and supporting statutory management and implementation for contracted banks.

Transition to compliance

Q19: Do you agree that 6 months is an appropriate amount of time for banks to provide the Reserve Bank with a plan for how it will come to compliance with the revised outsourcing policy, noting that its form has not yet been finalised?

Generally, yes. Whilst it is difficult to comment upon individual banks (and we are unable to comment on those banks dependent on their parent), we would expect risk assessments to be in place for most banks, particularly when considering the requirements to meet risk management, stress test and 'Use Tests' required by Basel II/III adoption. Although the provision of a plan will be more challenging for those that do not and have not considered the risks, a bank's senior management, risk and audit groups should be able to establish a proposal within a 6 month time period.

Q20: Do you agree that 2 years would provide a sufficient timeframe to reach compliance with the policy?

Yes. For the reasons stated within our previous answers.

Q21: How much do you think transitioning to compliance will cost and how could those costs be reduced by an appropriate transitional path?

Whilst IBM is not able to comment on this aspect, and it would be unique to each bank, we would expect that an existing mature vendor/outsourcing management program should be in place and would address most requirements. IBM supports its clients by establishing detailed vendor client management routines and the provision of detailed Service Level Reporting and contract/agreement management routines.

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